CHAPTER -2

PERFORMANCE APPRAISAL AND ‘CAMEL’ MODEL, A CONCEPTUAL FRAME WORK
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2.1 MEANING AND CONCEPT OF PERFORMANCE

The word, ‘performance’ is derived from the word, ‘parfourmen’, that means ‘to render’ or ‘to do’. It refers to the act of performing an activity. It means the act of accomplishment or execution. It refers to the level to which a task has been accomplished. From the view point of banks, it takes in to account the way of their progress.

In the words of Robart Albanese, “Word Performance is used to mean the efforts extended to achieve the targets efficiently and effectively. The achievement of targets involves the integrated use of human, financial and natural resources.”\(^1\)

Opinion of Frich Kohlar, “The performance is a general term applied to a part or to all of the conduct of activities of an organization over a period of time, often with reference to past or projected cost, efficiency, management responsibility or accountability or the like.”\(^2\)

On the basis of above general meaning and two definitions, it can be conclude that ‘performance’ means not only presentation, but it also refers the sense of quality and ultimate result, that has been achieved by the management of any business.

It compares the present achievements with that of past in the context of whatever aims, goals or targets that were set by the management. It covers the financial cost and other social dimensions also from the view point of this present study. So, performance is the word that is used to exhibit business enterprise’s extent of success, failure, reasons, conditions, compliance etc.

2.2 MEANING OF FINANCIAL PERFORMANCE

Financial performance represents the task of executing financial activity. It indicates to the extent with which financial objectives or targets have been fulfilled. Here company’s financial performance in the context of its policies, operation and execution is measured in monetary terms; it can be measured for financial health of any business enterprise for a particular period of
Financial performance of one enterprise can also be compared with other similar business enterprise in the same industry.

Financial performance analysis is a process of systematically making a proper, critical and comparative evaluation of profitability and financial health of firm or banks through the applications of financial statement analysis.

2.3 **HOW TO MEASURE PERFORMANCE: CONCEPT OF MEASUREMENT**

A performance indicator or a key performance indicator (KPI) is a type of performance measurement. A business enterprise may use KPI to evaluate its success or to evaluate the success of a specific activity in which it is engaged.

While P.C. Tripathi defines measurement as, “The assignment of numerals to characteristics of objects, persons, states or events according to rules. What is measured is not the object, person, state or event itself but some characteristics of it, when objects are counted, for example, we do not measure the object itself but also its characteristic of being present. We never measure people only by their age, height, weight or some other characteristics.”

In a business enterprise, specific goals and objectives are designed, and to achieve or fulfill these goals and objectives, various groups or association of people are formed or established. These groups of people requires their performance measurement or analysis to decide as how much business enterprise has got through its activities towards its goals or objectives, which were designed or decided well in advance.

In the context of performance measurement of business enterprise, a set of financial statements can fulfill that goal or objective.

According to Eldon S. Hendriksen, “The primary focus of financial reporting is information about an enterprise’s performance provided by measures of earnings and its components.”
The real purpose of preparing financial statements is to reveal the financial performance that has been achieved by the business enterprise. A set of financial statements is systematic collection of data through logical and consistent accounting policies and procedures. Normally the term of financial statements means to two key basic statements. One is the balance sheet and second is the income statement (i.e. profit and loss account.)

The balance sheet is a static statement, which shows the financial position of the business enterprise on a particular date. It is a summary of financial position on a particular date. While, the income statement (i.e. profit and loss account) shows the performance of operations of business enterprise for fix particular period. It is a summary of business firm’s revenue and expenses for a specific time period, ultimately showing either net profit or loss for that specific time period.

According to met calf R.W. and P.L. Titard, “The analysis of financial statements is a process of evaluating the relationship between component parts of financial statements to obtain a better understanding of the firm’s position and performance.”

Appraisal or analysis of financial statements is a good support and aid to financial performance analysis of business enterprise. Measurement of financial performance through this financial statement analysis gives a useful information about the financial strength and weakness of the business enterprise and thus measures the performance of various business in the same industry not only to judge the individual business performance but also to indicate a specific trend of improvement or deterioration among the various units of the same industry.

2.4 AREAS OF PERFORMANCE

In a business enterprise, by making a comprehensive assessment, certainly the performance of different types of tasks and activities accomplished in various area of business operations can be improved or modified. These areas of operations may be defined as the area of performance. Financial experts often
consider or assess the following important areas for the performance or measurement or analysis.

[1] Performance of Productivity
[2] Performance of Profitability
[4] Performance of Liquidity

2.5 MEANING AND CONCEPT OF ‘APPRAISAL’

“Appraisal” is associated to scrutiny of the operating system of business enterprise as a whole. It is an application of various tools and techniques to assess, to measure and then to derive or draw some conclusions. According to Sudha Nigam, “Appraisal is a technique to evaluate past, current and projected performance of concern”.  

There can be two types of appraisal: [i] Internal and [ii] External. Internal appraisal is a continuous process that is being regularly implemented in big business enterprise with having objects to verify the optimal utilization of all resources in the business.

According to Pitt Francis, “Internal appraisal of the company not only means making some of having adequate human, physical and financial resources but seeing that they are optimally employed.”

2.6 THE CONCEPT OF PERFORMANCE APPRAISAL

When the word ‘appraisal’ joined or correlates with of ‘performance’, it becomes or refers to ‘Performance appraisal’. In the banking sector, ‘Performance appraisal’ covers a wide area of study. The focus of entire process is on the proper and efficient utilization of banking resources.

As a concept, ‘Performance appraisal is nothing but a developmental tool for the business enterprise or for the banks. It cannot take place of final assessment which is more important or ultimate outcome of the entire process of appraisal.
However, every time, the performance appraisal may not be able to give a true and correct answer of every question, that came into focus, but certainly it can throw the light on the way, which can be utilized for further enquiries. Erich A. Helfert stated, “The person analyzing performance appraisal must have clear ideas in mind that which tests should be applied and for what specific reasons. One must define the view points to be taken, the objectives of the analysis and possible standards of comparison.”

2.7 THE CONCEPT OF FINANCIAL APPRAISAL

“Financial Appraisal is a scientific evaluation of profitability and financial strength of any business concern.”

Financial statement (i.e. Profit and Loss account and Balance Sheet) are prepared and published by the company at the end of the year. This set of financial statements can become a base for the financial appraisal of any business enterprise including banks. Though some additional value added statements are also prepared with that of annual accounts, as a part of annual report. According to Kennedy and McMillan, “Financial statement analysis attempt to unveil the meaning and significance of the items composed in profit and loss account and balance sheet, so as to assist the management in the formation of sound operating financial policies.”

The financial statement analysis provides an indicative and enough guideline regarding the behavior of various financial variables for measuring the performance of various business enterprises in the industry or organization. However, for proper understanding and interpretation of these financial statements, a basic understanding of the concept and principles underlying their preparation is necessary for the users of these financial statements.

2.8 IMPORTANCE (SIGNIFICANCE) OF PERFORMANCE APPRAISAL:

Interest of various groups is associated with the performance appraisal or financial performance of business enterprise or banks. Therefore, these groups are always interested in analyzing the financial performance or appraisal of
the banks. Importance of performance appraisal or financial performance analysis erupts or awakens from the viewpoint of all this various groups. The type of appraisal or analysis varies accordingly to the specific interest of the respective party or group involved in it. These various parties or groups are as under:

2.8.1 **from the viewpoint of management**

Management is always interested in internal control, better financial position and performance. Management can not only measure the outcome of its own plan and business policies by making performance appraisal, but also evaluate the effectiveness of its policies. This is very useful to determine regarding continuance of present policies or to adopt new policies.

2.8.2 **from the viewpoint of Creditors**

Creditors are always interested in the liquidity of the business enterprise. So, their interest is in appraisal of firm’s liquidity. Creditors can make performance appraisal by applying various ratios and can avail the real information regarding liquidity and other aspect of business enterprise.

2.8.3 **from the viewpoint of Government and Reserve Bank of India**

Government and Reserve Bank of India are always interested regarding the performance of banking sector as a whole, because directly it is related with growth of economy. On the bases of performance appraisal of banks, not only the government and RBI can have the idea and knowledge of growth of banking sector and economy as a whole, but also they can plan tax incentives and other policy measures for the banking sector considering the present and future of banking sector and economy.
2.8.4 from the view point of Investors

Investors and potential investors are always interested in present and future earnings as well as stability and improvement of these earnings. So, their interest lies in appraisal of business enterprise’s profitability, productivity and financial condition. According to Erich A. Helfert, “Importance of performance lies for owners/potential investors should know easily. The financial position of a company known by return on net worth, return on common equity, earning per share, cash flow per share, dividend per share, dividend yield, dividend coverage, price earnings ratio, market to book value, pay out/retention.12

2.8.5 from the view point of Depositors and Bondholders

Depositors and bondholders are interested in the cash flow, liquidity and profitability of the bank or business enterprise. So, they are interested in appraisal of cash flow and liquidity, present and future profitability as well as capital structure. Depositors and bondholders can have all these aspects by making or referring performance appraisal of various banks.

2.8.6 from the view point of Employees and trade Unions

Employees are one of the important pillars of banks. They are interested in the profit, cash flow and financial position of the bank or enterprise. So, employees can know all these things by referring performance appraisal of banks. Trade Unions are also interested in the details of financial performance due to their demand for increase in salaries, facilities and other benefits.

2.8.7 from the view point of suppliers of Long Term Finance

Suppliers of Long Term debt or finance are interested in probability and liquidity of the business enterprise. This category of people will focus on solvency as well as survival of the business also, because they are giving finance for a bit longer period of time. They can know all these aspect by referring performance appraisal of business enterprise.
2.8.8 from the viewpoint of Society

There are various elements or agencies or groups in Society, who are directly or indirectly associated with every business enterprise or bank. Sometimes it is called business effect on external Environment of Society. Every enterprise or bank has a reasonable responsibility towards the society also. In the case of a bank, such associated elements or agencies may be like tax consultants, economist, stock exchanges, media, credit institutions, taxation authorities, Investors, Job aspirants etc. Their interest in the performance appraisal of banks is called the ‘General Interest’ of the society. Always the society is very eager to looks forward to know regarding the social performance of any business enterprise, like environmental effects, social welfare schemes, employment opportunities etc.

2.9 PERFORMANCE APPRAISAL: USEFULNESS IN MANAGEMENT FUNCTIONS

The management of any business enterprises or banks needed many types of information for the management (operations) of the business. Especially, there are some managerial tasks or functions for which continuous flow of quantitative and qualitative information is inevitable. For example, planning, control, directions, budgeting, decision making etc.

Planning is a process of decision for the future course of action in advance. Planning according to, Delton F. McFarland, “a concept of executive action that embodies the skill of anticipating, influencing and controlling the nature and direction of change.” Planning always demand information and performance appraisal is very useful in the terms of source of quantitative information. It is also very useful to management because flow of information will enable them to carry out control over daily operations with an object of eyeing or achieving maximum efficiency. Effective control ultimately directs every activity towards achievement of predetermined goals of business.
Sometimes, management has to give direction to their employees according to situation and performance. Performance appraisal provides the information for this task. Likewise, decision making for budget, expansion etc. performance appraisal becomes a base of sound information.

Performance appraisal provides vital information to management, which is very useful in the profitable operation of business and for effective utilization of all the resources.

2.10 **OBJECTIVES OF PERFORMANCE APPRAISAL**

Every activity, especially measurement or assessment or appraisal of performance of any firm should have its objectives, to make it fruitful. Performance appraisal is technique to measure or assess past, present and future projected performance of a business enterprise. It is concerned with the analysis of financial as all as non-financial information of the firm. Though, the present study covers only analysis of financial data. The main objectives of this performance appraisal is to assess past and present performance, Financial Position, Capital Adequacy, Assets Quality, Management ability, earning, liquidity and future prospects of the business unit or banks.

According to R.N. Anthony, “The overall objective of any economic activity is to earn a satisfactory return on the funds invested in it, consistent with maintaining a sound financial position.”

2.11 **RATIO ANALYSIS AS A TOOL/TECHNIQUE FOR PERFORMANCE APPRAISAL OR FINANCIAL PERFORMANCE ANALYSIS**

In order to judge or measure performance appraisal or the financial performance of an enterprise, analyst needs certain tools and techniques to be applied on various aspects of financial statements. Ratio analysis is considered to be one of the most powerful and widely used tools for it. In simple terms, “Ratio expresses the numerical relationship between two or more things.” This relationship is expressed in different ways: Simple Figure
or number (2:1), Percentage (20%) and times (4 times). The technique of Ratio analysis is the method of determining and interpreting significant numerical relationship based on financial statements. According to Batty, “Accounting Ratios describe the significant relationship which exists between figures shown in a balance sheet, in a profit and loss account, in a Budgetary Control.”

It is noticed that the absolute financial figures published in financial statement (i.e. Profit and Loss account and Balance Sheet) does not give and clear idea or position about the performance of business enterprises or banks. Use of ratio analysis can become meaningful to determine profitability and overall financial condition only when there is a comparison. Two types of comparison can be made: [1] Comparison of present ratios with that of past ratios of the same firm. By doing this, analyst can determine the performance of major components of business and ultimately financial position of the business enterprise over the period of time. It can show either improvement or deterioration over the period of time in the context of past performance and [2] Comparison of the ratios of the business enterprise or bank, with that of other similar business unit or bank, doing business in the same industry at the same point to time. This type of comparative analysis would be very useful to determine relative financial performance and position of the Bank, which also provides deep insight for comparative improvement from the future point of view.

Ratio analysis discloses whether the financial position of business enterprise or bank is improving or deteriorating over a specific time period. It plays an important role in measuring the financial strengths and weakness of the business enterprise or bank. Universally, ratio analysis has been used for performance appraisal of business. Ratio analysis also helps to summarize the huge quantities of financial data and to arrive for a qualitative judgment about the financial performance of business enterprises or banks.

Ratio analysis is a very useful tool to determine performance of a firm. But one must be careful and vigilant about the basic limitations of ratio analysis. It is a tool or technique of analysis only. It paves or show the way for
effective business operations by undertaking an appraisal only. It cannot give the full picture but give only some Glimps and indications, which cumulatively helps a lot in performance appraisal or financial performance of business enterprise. Simultaneously, for effective financial analysis or performance appraisal, selection of proper ratios is also very important.

2.12 “CAMEL MODEL”: CONCEPTUAL FRAMEWORK

2.12.1 Introduction

Indian banking sector has been passing through a complex, but comprehensive phase of reform and restructuring since 1991. The whole banking scenario has changed a lot in the recent past on the base of implementation of Narasimham Committee Report and other reforms. Further, Base-III norms also introduced.

Entire reform process has been implemented with a view to make the banking system very sound, efficient, internationally competitive and joining its links with economy for promotion of savings, investments and overall inclusive growth. Though, complete turnaround in Indian Banking Sector performance is not expected in a hurry till the economy turn around and growth of economy rebound. In spite of this, some signs of slow and gradual improvement are there looking in the horizon in some aspects or indicators under the ‘CAMEL” model of framework.

The ‘CAMEL’ rating is a supervisory rating system originally developed in the U.S. to classify a bank’s overall position. It is applied to every banks and credit union in the U.S. and also implemented outside the U.S. by various banking supervisory regulators.¹⁵ The uniform financial institution rating system commonly termed to the acronym ‘CAMEL’ rating was accepted by the federal financial institution examination council on November 13, 1979 and then afterwards by the National Credit Union Administration in Act, 1987. The ratings are given based on the ratio analysis of the financial statement.

The Banking Regulation Act, 1949 empowers the Reserve Bank of India to inspect and super wise commercial banks. These powers are executed through
on-site inspection and off-site surveillance. In November, 1994, RBI set up the Board of financial Supervision (BFS) for integrated supervision over all credit institutions. The whole mechanism of supervisory system was realigned to suit the changing requirement of a sound and stable financial system. In January, 1995, the Board of Financial Supervision established an audit subcommittee, the main function or focus of which is on upgradation of various auditing functions and practices.

In 1995, The Reserve Banks of India established a working group under the chairmanship of Shri S. Padmanabhan to review the entire supervision system of banking sector. On the base of recommendations and suggestions given by this committee, A rating system namely (based on an internationally adopted model) “CAMEL” Model, which was later modified as ‘CAMELS’ was introduced for banks, commencing from July, 1998 audit and inspection cycle. Committee recommended that the banks should be rated on a five point scale (1 to 5) based on the guidelines of the international “CAMEL” rating model.

“CAMEL” Model measures banks on the following five parameters.

[1] Capital Adequacy
[2] Asset Quality
[4] Earning
[5] Liquidity

2.12.2 **Explanation of “CAMEL” Model:**

**[1] Capital Adequacy**

Capital Adequacy is the capital expected to maintain balance with the risks exposure of the bank, like credit risk, market risk and operational risk with a view to absorb the potential losses and protect the bank’s debt holder. The Capital adequacy represents the overall financial condition of the bank and its ability to meet the need for additional capital. Capital adequacy of banks is measured by the ratio of capital to risk weighted assets (CRAR). A sound
capital Adequacy ratios or position strengthen the confidence of various stakeholders in the bank.

[2] **Asset Quality**

It takes into consideration the percentage of banks loan that are NPAs (Non performing assets). The main or prime reason behind determining the asset quality is to ascertain the ingredients of NPAs as a percentage of total assets. It also measures the movement of NPAs. The gross non-performing loans to gross advances ratio is an indication towards the Quality of credit decisions of the bank management. Higher NPAs means that loans given by banks are of lower quality. It affects by two ways: First, it increases the provision and reduces profit and second it affects the internal accruals for banks in the form of reduced profit. So it is not a good thing for banks.

[3] **Management Efficiency**

It indicates a subjective analysis for measuring the performance of management. There are so many ratios that indicates the performance of management, e.g. business per branch, net profit per employee, Return on net worth, non interest expenditures to total assets etc.. Higher non-interest expenditures ratios (It includes variety of expenses) implies that bank management is not able to control some needless expenses.

[4] **Earning Quality**

This rating reveals not only the Quantity and trend in earning, but also the factors that may affect the sustainability of earning. It refers to the net profit made by bank after taking into account all the factors. Higher earning shows that bank’s performance is healthy but simultaneously it is very important to see that this good earning is on account of main or core banking, i.e. interest income on lending operations. This aspect gains importance now in a days in the light of argument, that one big portion of bank’s earning is earned through non-core activities, like treasury operations, Investment advisory services, corporate advisory service and other activities. So, earning from core banking activity is very important.
Liquidity

Liquidity is one of the important parameters to evaluate the performance of a bank. This parameter ascertains the ability of a bank to pay its liabilities as and when they matured. Higher liquidity implies that the bank will be able to meet any untimely withdrawals by the depositors. Not only that but sometimes in a liquidity crunch situation in the market, bank can earn good interest income in call money market also. There must be sufficient liquidity sources for present and future requirements and also availability of assets that can be readily convertible in to cash without undue loss. Liquidity of a bank can be measured by various ratios.

So, Indian banks are rated as per above supervisory rating model ‘CAMEL’, approved by the Reserve Bank of India.

2.12.3 The Importance of ‘CAMEL’ Rating in Banking Supervision

Objects of ‘CAMEL’ model are to provide a good, actuate and consistent assessment of a bank’s financial position in the various key areas like capital, asset quality, management, earning quality and liquidity. Muhammad (2009) claims, “that the strength of all these factors would measure the overall strength of the bank. The quality of each component further underlines the inner strength and how far it can take care of itself against the market risk.”

Furthermore, in a situation where, financial markets are increasingly becoming more and more integrated, providing a common model for measurement or assessment of overall financial performance of the banks is of a big importance for financial markets in general and banking sector in particular.

“CAMEL” model of rating is also provides significant compliance data or information that is needed for the regulators. This information helps them to ensure the extent of supervisory concern and response to issue timely warnings to reduce the negative effects on the banks. “In the financial crisis of 2008, this rating system was being used by American Government and responded to the crisis to help decide, which banks require the special help and which
not as part of its capitalization program authorized by the Emergency economic stabilization Act of 2008.\textsuperscript{17}

So, ‘CAMEL’ model is very useful. Sometimes, its index works as a bank’s failure predicting model also. In nutshell, still ‘CAMEL’ model is very important for the banking sector and banking regulator as a whole.
**References:**


